

# CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM STATEMENT OF INVESTMENT POLICY

## FOR ~~RISK MANAGED~~ ABSOLUTE RETURN STRATEGIES PROGRAM

~~April 21, 2008~~ October 17, 2011

*This Policy is effective immediately upon adoption and supersedes all previous Absolute Return Strategies (formerly known as Risk Managed Absolute Return Strategies) Program policies.*

### I. PURPOSE

The California Public Employees' Retirement System ("CalPERS") Total Fund Statement of Investment ~~Policy~~, Policy adopted by the CalPERS Investment Committee ("Committee"), sets forth CalPERS overarching investment purposes and objectives with respect to all its investment programs.

This document sets forth the investment policy ("Policy") for the ~~Risk Managed Absolute Return Strategies Program ("Program", "RMARS"), formerly known as the Risk Managed Absolute Return Strategies (RMARS) Program.~~ The design of this Policy ensures that investors, managers, consultants, and other participants selected by ~~the California Public Employees' Retirement System ("CalPERS")~~ take prudent and careful action while managing the Program. Additionally, use of this Policy assures sufficient flexibility in managing investment risks and returns associated with this Program.

### II. STRATEGIC OBJECTIVE

The Program's strategic objective is to broaden the opportunity set of CalPERS investment portfolio by utilizing Absolute Return Funds to capitalize upon investment opportunities not available in ~~traditional public markets investments~~ using traditional approaches to investing in public markets.

The Program shall be managed to accomplish the following:

- A. Enhance CalPERS long-term total return, subject to ~~the careful management of risk, consistent with an appropriate~~ risk budget.
- ~~B. Hedge against long-term liabilities.~~
- B.C. Provide diversification to CalPERS overall investment program.

### III. RESPONSIBILITIES

A. CalPERS Investment Staff ("Staff") is responsible for the following:

1. All aspects of portfolio management, including monitoring, analyzing, and evaluating performance relative to the appropriate benchmark.
2. Evaluating and selecting Absolute Return Fund investment opportunities.
3. Reporting to the Committee no less than annually, and more often if needed, about the ~~performance of the Program's~~ composition and performance.
4. Monitoring the implementation of, and compliance with, the Policy. Staff shall report material violations of this Policy at the next Committee meeting, or sooner if deemed necessary. Staff will also report material concerns, problems or changes related to the Policy and Program to the Committee as appropriate. These reports shall include explanations of any violations or other matters and appropriate recommendations for corrective action.
5. Evaluating and selecting [Absolute Return Fund Strategic Advisor\(s\)](#) ("Strategic Advisor(s)"). The selection process shall use specific criteria with the objective of identifying and selecting Strategic Advisor(s) that have, but are not limited to, the following characteristics:
  - a. Multiple senior personnel with significant amount of experience in the Absolute Return Fund industry.
  - b. Breadth of expertise across many fund strategies.
  - c. Robust quantitative disciplines for risk controls.
  - d. Sound quantitative process for constructing a portfolio.
  - e. ~~Attractive fee arrangements~~ Proper alignment of interests with CalPERS, including but not limited to attractive fee arrangements.
  - f. ~~Desire~~ Willingness and ability to work with CalPERS in a labor intensive fashion, including but not limited to training CalPERS staff.

- g. Commitment to providing CalPERS access to the most senior people within their organization.
    - h. Willingness and the ability to assist CalPERS to the extent as necessary to in securing scarce capacity, proper alignment of interests, appropriate levels of CalPERS control of assets, and position level transparency from Absolute Return Funds.
  - 6. Monitoring the Program's investments and selected Investment Manager(s) performance to determine if the managers' actions and ~~investment results~~ are consistent with this Policy and other applicable CalPERS policies.
  - 7. Overseeing the reconciliation of each investment by the Program's Hedge Fund Administrator in accordance with Generally Accepted Accounting Principles on a monthly basis. The Hedge Fund Administrator shall provide an accounting ledger each month to Staff.
  - ~~7.8. Continually reviewing the efficacy of absolute return oriented investing.~~
- B. The General Pension Consultant ("Consultant") is responsible for:
- 1. Monitoring, evaluating, and reporting periodically to the Committee on the performance of the Program relative to the appropriate benchmarks and this policy and other applicable CalPERS policies.
  - 2. Continually reviewing the efficacy of absolute return oriented investing.
- C. Strategic Advisor(s)' responsibilities may include, but are not limited to, the following:
- 1. Assisting Staff in conducting the initial screening of potential Absolute Return Fund investments.
  - 2. Assisting Staff in performing front and back office due diligence and evaluating the legal terms of prospective Absolute Return Fund investments.
  - 3. Providing written opinions regarding Staff's recommendations to take significant actions such as allocating to or redeeming from an Absolute Return Fund.

4. Assisting staff in monitoring and evaluating the performance of the Program's investments relative to appropriate benchmarks and this Policy and other applicable CalPERS policies, in accordance with its agreement with CalPERS.
  5. Providing advice and feedback on strategic initiatives and policies for the Program's future success.
- D. The Investment Manager(s) is responsible for aspects of portfolio management as set forth in the Investment Manager's agreement with CalPERS and shall fulfill the following duties:
1. Communicating with Staff as needed regarding investment strategy and investment results. The Investment Manager is expected to monitor, analyze, and evaluate performance relative to any agreed-upon benchmarks.
  2. Cooperating with information requests by Staff and the Program's Hedge Fund Administrator; and Strategic PartnerAdvisor(s) requests for information.
  3. Complying with CalPERS reporting requirements, including but not limited to, accounting for fees and expenses.

#### **IV. PERFORMANCE OBJECTIVE AND BENCHMARK**

##### **A. Performance Objectives**

Absolute Return Funds are highly specialized investments; therefore, CalPERS shall establish performance objectives for each Absolute Return Fund. These objectives shall be set at levels that are consistent with the strategy employed by each Absolute Return Fund's Investment Manager.

The Program shall pursue the following objectives:

##### **1. Targeted Risk**

The Program level risk target shall be no greater than one-half the five year annualized volatility forecast of the CalPERS Internal Wilshire 2500 Equity Index Fund, and that Global Equity Program benchmark. The Program shall be managed so that in any one month the decline in net asset value shall not exceed 10%.

## 2. Targeted Return

~~On an annual basis and for purposes of performance appraisals, the The Program level return target shall be the return of the one-year U.S. Treasury Bill rate plus 5% over a full market cycle (three to five years).~~

## 3. Targeted Liquidity

~~The majority of Absolute Return ProgramFund assets within the Program are expected to be subject to an initial lock-up of one year or less. In addition, the majority of other than those held in Funds of Absolute Return Funds assets within the Program are expected to be subject to quarterly or more frequent liquidity after the expiration of any lock-upconvertible to cash within 90 days in ordinary liquidity conditions.~~

## B. Benchmark

~~The benchmark for the Risk-Managed-Absolute Return Strategies Program is specified in the Benchmarks Modification and Benchmark Details Policy. These benchmarks shall be established prior to investment and shall be documented with each Investment Manager.~~

# V. INVESTMENT APPROACHES AND PARAMETERS

## A. Investment Approach

~~1. The Program shall invest in Absolute Return Funds with the intent to enhance CalPERS Total Fund return while diversifying CalPERS Total Fund riskshall complement the traditional active management vehicles in the Global Equity Markets and AIM Investment Programs. ARS Program investments should not overlap significantly with investments undertaken by other CalPERS investment groups or asset classes. Absolute Return Funds investments may include exposure to leverage (including implicit leverage through derivatives), or short selling of securities, or both.~~

~~The allocation of assets for the Program shall come from the active or passive investments from the Global Equity Markets ProgramARS Program investments should focus on management of total risk and on generation of returns independent of broad market movements. This differs from “benchmark-driven investing,” where risk management and return generation are measured by reference to a broad market benchmark; in such instances, most or all of an investment’s total risk may be broad market risk.~~

2. Successful Absolute Return Fund investing focuses on unique investment strategies and styles and on Investment Managers who possess unique skillsets and specialized expertise. The likelihood of Program success is enhanced where Investment Managers make a meaningful effort toward limiting asset growth in the strategy, ensuring a proper investment time horizon, and protecting CalPERS (or enabling CalPERS to protect itself) from potential negative impacts from actions of other investors. The approaches selected for inclusion in the ARS Program should not mirror traditional active management. The fees and expenses of investing in Absolute Return Funds may be higher than traditional active management, and CalPERS shall not invest in “absolute return” funds that simply engage in traditional active management approaches at higher fees.

~~The Program shall invest in Absolute Return Funds to generate the attractive risk to reward characteristics provided by these specialized and unique investment strategies.~~

3. ~~The Program shall invest in Absolute Return Funds through partnerships or other formation structures, e.g., limited liability companies (LLCs), where the Investment Manager has expertise in the specified mandates and in related areas material to the success of each investment strategy. The justifications for a limited partnership or similar structure such as an LLC include, but are not limited to, the following:~~

a. ~~Financial Firewall: The limited liability of a partnership or LLC arrangement is important since Absolute Return Funds sometimes use derivatives and leverage. CalPERS, as a limited partner or member, has the benefit of this limited liability.~~

b. ~~Access Unique Approaches with Limited Liquidity: The key to successful Absolute Return Fund investing is in selecting vehicles where the specialization of the investment is sufficiently unique that the partnership or LLC structure is justified in limiting asset growth in the strategy, ensuring a proper investment time horizon, and protecting CalPERS from the vagaries of other investors who may not be like-minded. The goal is to ensure that the approaches selected for recommendation do not mirror traditional active management. The fees and expenses of investing in Absolute Return Funds may be higher than traditional active management. CalPERS shall not fund Absolute Return Funds that simply invest in traditional active management approaches at higher fees.~~

c. ~~Access Unique Talent: The specialized and focused nature of Absolute Return Funds often requires more specialized investment skills than those needed for traditional active management. Some~~

~~of these investment professionals manage money only in the partnership format or LLC structure.~~

- ~~4. The negotiation of terms in Absolute Return Funds shall protect the interests of CalPERS, and shall address at a minimum the following issues:~~
  - ~~a. Alignment of Interests: Vehicle terms including fees shall be negotiated to align the Investment Manager's interest with CalPERS, acknowledging that market conditions may not permit "optimal" terms for each Absolute Return Fund. The fee structure, performance objective, restrictions on permitted investments, lock-up period, and other relevant terms shall seek to protect CalPERS in the event of adverse performance results, while ensuring that the limited liability status is maintained.~~
  - ~~b. Leverage: It is recognized that Absolute Return Funds may expose CalPERS assets to leverage, meaning that a fund's financial exposures may exceed its invested capital. Therefore, Program investments should only be made in investment vehicles which provide limited liability and thereby protect the Program from losing more than its invested capital.~~
  - ~~c. Reporting Requirements: Each Investment Manager will be required to provide financial and investment reports which comply with geographically appropriate accounting standards (e.g., U.S. GAAP, International Financial Reporting Standards) and which provide Staff adequate information to properly assess and account for performance, fees, expenses, invested capital, and any other items affecting the investment. Monthly and quarterly investment updates are expected of each Investment Manager.~~
- ~~5. The Staff and consultant shall continually review the efficacy of absolute return-oriented investing. Staff shall present a formal review of the approach to the Committee on an annual basis.~~

## **B. Investment Selection**

1. Absolute Return Funds may be selected if they enhance the Program's ability to achieve its overall investment objective. Absolute Return Funds may include investments in domestic equity, international equity, fixed income, commodities, currencies, and other securities investments through approaches that may include, but are not limited to, the following *strategies* (as defined by the leading industry-recognized absolute return fund indices):

- a. [Directional Trading](#)
  - b. [Event Driven](#)
  - c. [Fund of Absolute Return Funds](#)
  - d. [Multi-Process](#)
  - e. [Security Selection](#)
  - f. [Specialist Credit](#)
2. The following absolute return fund investment styles shall be considered for the Program that may include, but are not limited to, the following (as defined by the leading industry-recognized absolute return fund indices):
  - a. [Commodity Trading Advisors](#)
  - b. [Convertible Arbitrage](#)
  - c. [Distressed Securities](#)
  - d. [Fixed Income Arbitrage](#)
  - e. [Long/Short Credit](#)
  - f. [Long/Short Equity](#)
  - g. [Market Neutral](#)
  - h. [Merger Arbitrage](#)
  - i. [Multiple Arbitrage](#)
  - j. [Statistical Arbitrage](#)
3. Staff shall develop and maintain selection guidelines for prospective absolute return funds. To ensure conformity to the Committee's risk and return expectations, these criteria shall be subject to review by:
  - a. Staff;
  - b. Strategic Advisor(s); and



c. The Consultant.

The selection guidelines may include, but are not limited to, the following:

ad. Minimum requirements with respect to the following:

- (1) Investment Manager Investment Experience
- (2) Basic Investment Vehicle Terms
- (3) Investment Goals and Objectives
- (4) Degree of Leverage

be. Performance criteria

cf. Due diligence process

dg. Legal constraints or requirements

eh. Reporting requirements

fi. Quality control processes including, but not limited to, investment monitoring and risk control

gj. Other relevant parameters that may apply.

### C. Investment Parameters

Investment Managers in Absolute Return Funds shall operate under a ~~limited partnership agreement, or other similar legal structure, which includes~~ specific, written investment guidelines. The guidelines shall outline the Investment Manager's investment philosophy and approaches, representative portfolio characteristics, permissible and restricted securities and procedures, and a performance objective commensurate with the investment risk to be incurred.

Implementation of this Program shall comply at all times with applicable CalPERS investment policies.

### D. Risk Parameters

Each Program investment shall have a specified ~~a~~ set of risk parameters appropriate for that investment. Staff shall utilize the risk platform ~~that has been~~ (internally and/or externally developed) to measure and monitor

quantitatively the economic and investment risks associated with the Program, and shall further utilize the judgments and advice of the Strategic Advisor(s) and the Consultant to assess the qualitative risks inherent in managing the Program.

The Program shall not invest more than 10% of Program assets into any single Absolute Return Fund at the time an investment into that Absolute Return Fund is made.

#### **E. Investment Structuring**

1. The Program shall invest in Absolute Return Funds through limited partnerships or other legal structures such as limited liability companies (LLCs) which provide a defined term. Such legal structures are important because of the potential for Absolute Return Funds to utilize derivatives and leverage. CalPERS, as a limited partner or member, benefits from limited liability in Absolute Return Funds structured in such a manner.
2. The negotiation of terms in Absolute Return Funds shall protect the interests of CalPERS and shall address at a minimum the following issues:
  - a. Alignment of Interests: Vehicle terms including fees shall be negotiated to align the Investment Manager's interest with CalPERS. The fee structure, performance objective, restrictions on permitted investments, lock-up period, and other relevant terms shall seek to protect CalPERS in the event of adverse performance results, while ensuring that limited liability status is maintained.
  - b. Control of Assets: Vehicle terms shall be negotiated to minimize the likelihood of loss of control of CalPERS assets through the inappropriate use of suspensions, gates, or other actions which unnecessarily prevent CalPERS from taking the course of action most appropriate to fit CalPERS needs and duties.
  - c. Transparency of Risks and Exposures; Reporting Requirements: Vehicle terms shall be negotiated to ensure that Staff has adequate portfolio and position information to properly assess the risks and exposures associated with investment in a given Absolute Return Fund. Each Investment Manager will be required to provide financial and investment reports which comply with geographically appropriate accounting standards (e.g., U.S. GAAP.

International Financial Reporting Standards) and which provide Staff adequate information to properly assess and account for performance, fees, expenses, invested capital, and any other items affecting the investment. Monthly and quarterly investment updates are expected of each Investment Manager.

3. The Program has historically used an LLC called CalPERS Hedge Fund Partners, LLC ("CHFP") as the vehicle for CalPERS investments into Absolute Return Funds. CHFP's sole member is CalPERS, and CalPERS is the only beneficial owner of CHFP's holdings. CalPERS no longer benefits from utilizing CHFP. As a result the ARS Program now invests in the name of CalPERS instead of CHFP, and existing CHFP holdings are being transferred to CalPERS direct ownership.

## VI. CALCULATIONS AND COMPUTATIONS

Investors, managers, consultants, and other participants selected by CalPERS shall make all calculations and computations on a market value basis as recorded by CalPERS Custodian and the Hedge Fund Administrator.

## VII. GLOSSARY OF TERMS

Key words used in this policy are defined in CalPERS Master Glossary of Terms.

Approved by the Policy Subcommittee:	June 11, 2004
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Administrative changes made due to Policy Review Project:	June 16, 2009
Admin changes due to adoption of Benchmark Policy:	November 23, 2009
<u>Revised by the Policy Subcommittee:</u>	<u>October 17, 2011</u>

### **Absolute Return Fund**

Also known as "hedge fund." An actively managed portfolio that aims to generate positive returns independent of both up markets and down markets, in part by managing its exposure to the broad market movements. An Absolute Return Fund's ~~portfolio~~ manager tends to manage its market exposures and to utilize long and short positions, derivatives and leverage to accomplish its goal. An Absolute Return Fund is usually set up as a private partnership or an offshore corporation, and in almost all cases incorporates limited liability for passive investors.

### **Absolute Return Strategic Advisor**

A consultant or advisor to the ~~Risk Managed~~ Absolute Return Strategies Program with responsibilities that may include assisting Staff with the screening, evaluating, recommending, and monitoring of Absolute Return Funds for the program, or with assisting Staff in assessing strategic initiatives and policies for the program.

### **Commodity Trading Advisors**

Investment Managers who primarily or exclusively employ the global futures and options markets. These managers run funds which are sometimes referred to as "managed futures" funds. Commodity Trading Advisors tend to provide returns that have a strong trend following component and a positively skewed-return distribution. Commodity Trading Advisors must be registered with the Commodity Futures Trading Commission (CFTC) unless they are excluded or exempted from registration.

### **Convertible Arbitrage**

A hedge fund strategy that typically involves purchasing a convertible security and simultaneously shorting the common stock of the same company. The convertible security can be the company's preferred stock or debt, secured or unsecured.

### **Derivatives**

An instrument whose values are is based on the performance of an underlying financial asset, index, or other investment. Classes of derivatives include futures contracts, options, currency forward contracts, swaps, and options on futures.

### **Directional Trading**

A strategy used by investors that open positions, either long or short, on the belief that they are able to correctly predict the movement of price in a security, industry, or market. This strategy is usually employed on equity securities by hedge funds that make directional bets on value/growth, large cap/small cap, net long position or net short position.

### **Distressed Securities**

Debt or equity securities of companies that are in financial distress. These securities tend to trade at significant discounts and attract investors that perceive a turnaround.

### **Event Driven**

Strategies that invest in companies with "special situations" designed to capture price movement generated by a significant pending corporate restructuring, liquidation, bankruptcy, or reorganization.

### **Financial Firewall**

The legal protection from financial liability extending beyond the value of the investment in a Limited Liability Company, ~~or~~ Limited Partnership, or similar structure.

### **Fixed Income Arbitrage**

This investment style is comprised of hedge funds that seek to arbitrage from price anomalies between related interest rate securities. The hedge fund shall invest opportunistically in interest rate swaps, U.S. and non-U.S. government bonds, forward agreements, etc.

### **Fund of Absolute Return Funds**

An investment approach where a Fund invests in multiple absolute return vehicles that result in one diversified portfolio. Diversification is created by including absolute return funds utilizing different investment strategies.

### **Generally Accepted Accounting Principles (GAAP)**

The common set of accounting principles, standards, and procedures. GAAP is a combination of authoritative standards (set by policy boards) and the accepted ways of doing accounting.

### **Hedge Fund Administrator**

The entity responsible for maintaining the accounting records for the ~~Risk-Managed~~ Absolute Return Strategies Program.

### **Investment Manager**

A professional or firm responsible for managing a securities portfolio for an investor. In return for a fee, the investment manager has the fiduciary responsibility to choose and manage investments prudently for their client.

### **Leverage**

A condition where a portfolio's market obligation may exceed the market-value-adjusted capital commitment by the amount of borrowed capital (debt).

### **Limited Liability Companies**

An alternative structure to ~~a~~ Limited Partnerships. It is often described as a hybrid between a corporation and a partnership because it offers limited liability like a corporation and single taxation on income like a partnership.

### **Limited Partner**

An investor in a limited partnership. Limited partners provide the capital but have no direct involvement in the management of the fund. Limited partners have limited liability but also have limited control over the management of the fund.

### **Limited Partnership**

The most common format used in structuring private equity investments. Limited partners provide the capital but have no direct involvement in the management of the fund. Limited partners have limited liability but also have limited control over the management of the fund.

### **Liquidity**

The ability to quickly convert a particular investment into cash at a low transaction cost.

### **Long/Short Credit**

This investment style is comprised of hedge funds that seek to arbitrage between the different debt instruments within a company's capital structure. The hedge fund seeks to realize returns from shifts in the credit spreads between the debt instruments.

### **Long/Short Equity**

This investment style is comprised of hedge funds that take both long and short equity positions to extract the maximum value from their investment information/analysis.

### **Market Neutral**

An investment strategy employed by hedge funds that attempts to remove or neutralize systematic market and industry risk, while focusing on stock selection risk. This strategy attempts to profit from the current direction of the market by taking both long and short positions at the same time.

### **Merger Arbitrage**

An investment strategy employed by hedge funds in which the stocks of the merging companies are simultaneously bought and sold in an attempt to create a riskless profit.

### **Multi-Process**

Strategies that invest in multiple hedge fund styles within a single hedge fund structure. The hedge fund allocates assets based on the opportunities among the various hedge fund styles to create the best return/risk profile for the product. The most common hedge fund styles utilized are merger arbitrage, equity long/short, convertible arbitrage, and volatility arbitrage.

### **Multiple Arbitrage**

An investment strategy employed by hedge funds that employ more than one arbitrage strategy within a single hedge fund. The hedge fund allocates assets based on the opportunities among the various arbitrage strategies to create the best return/risk profile for the product. The most common arbitrage strategies are merger arbitrage, fixed income arbitrage, convertible arbitrage, and volatility arbitrage.

### **Partnership Agreement**

~~Legal document that sets forth the terms and conditions of an investment vehicle. The partnership agreement also establishes the roles of general and limited partners.~~

### **Risk**

A measurable probability of losing or not gaining value. Risk is differentiated from uncertainty, which is not measurable. Risk in this context is also referred to as "standard deviation", which is a statistical measure of the degree to which an individual value in a probability distribution tends to vary from the mean of the distribution.

### **Risk Budget**

An investment approach where one uses measures of risk to assist in the allocation, management, and monitoring of the investments of an entity, such as a pension fund.

### **Security Selection**

Strategies that seek to mitigate market factors through a variety of hedging techniques with the objective of providing a return based solely on its stock/bond selection analysis.

### **Specialist Credit**

Strategies that seek to profit from price anomalies between the variety of debt instruments (i.e., government, corporate, high yield, sovereign, etc.) and convertible bond instruments.

### **Statistical Arbitrage**

This investment style is comprised of hedge funds that utilize quantitative models to remove all common sources of risk from an equity portfolio (i.e., capitalization, book to market value, dividend yield, etc.) so that only stock selection risk remains. Different from market neutral managers in that quantitative factor models are used to identify and minimize.